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Economics Revision Focus: 2004

AS Economics

Government Failure

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Revision Focus on Government Failure

AS Syllabus Requirements

Candidates should appreciate that **government intervention does not necessarily result in an improvement in economic welfare.** Governments may create rather than remove market distortions. **Inadequate information, conflicting objectives** and **administrative costs** should be recognised as possible sources of government failure

A failure of the free market and the price mechanism to deliver an allocatively efficient allocation of scarce resources is normally regarded as justification for some form of **government intervention** in the economy. This intervention is designed to **correct for instances of market failure** and achieve an improvement in economic and social welfare.

Market failure can occur in several different ways:

1. Under-provision of merit goods
2. Over-consumption of de-merit goods
3. Non-provision of pure public goods by the free market
4. A failure of the signalling function of the price mechanism to take into account negative and positive externalities arising from production and/or consumption
5. Factor immobility leading to a loss of productive efficiency
6. The exploitation of a dominant position in a market by a firm(s) with monopoly power
7. An inequitable distribution of income and wealth in society
8. Imperfect and asymmetric information among buyers and sellers in different markets

But what if intervention leads to further inefficiencies? What if government policies prove to be costly to implement but ineffective in achieving their desired outcomes? What happens if intervention **distorts markets still further** leading to a further **loss of allocative efficiency**?

What is Government Failure?

Even with good intentions governments seldom get their policy application correct. They can tax, control and regulate but the eventual outcome may be a **deepening of the market failure** or even worse a new failure may arise. Government failure may range from the trivial, when intervention is merely ineffective, but where harm is restricted to the cost of resources used up and wasted by the intervention, to cases where intervention produces new and more serious problems that did not exist before. The consequences of this can take many years to reverse.

Government failure in a non-market economy

The collapse of the Soviet Union in the late 1980s marked the failure of command or state-run economies as a means of allocating resources among competing uses. The essence of a command economy was that the state planning mechanism would decide what to produce and how to produce it and for whom to produce.

Government failure occurred when the central planners produced products that were not wanted by consumers – a loss of allocative efficiency, since there was no price mechanism to signal changes in consumer preferences and demand. Another fundamental failing of the pure command economy was that there was little incentive for workers to raise productivity; poor quality control; and little innovation by firms as no profit motive existed. Command economies also suffered massive environmental de-gradation because they did not posses structures for valuing the environment and giving consumers and producers the right incentives to protect their environmental heritage.

All of these economies are now moving towards the western mixed economy, though at varying speeds and with varying success. Ten countries have been accepted as new members of the European Union in May 2004, some of them former state-run economies in the Eastern Block. Countries such as Hungary, the Czech Republic and Poland are all moving towards a market based system for the allocation of resources for example through programmes of privatisation and market liberalisation.

Possible Causes of Government Failure

Government intervention can prove to be **ineffective, inequitable and misplaced**. There is a growing body of research in the economics literature on this topic – some of which uses highly mathematical techniques to analyse public policy-making. We will focus instead on the underlying reasons and consider some topical examples along the way.

(a) Political self-interest

The pursuit of **self-interest** amongst politicians and civil servants can often lead to a misallocation of resources. For example decisions about where to build new roads, by-passes, schools and hospitals may be decided with at least one eye to the political consequences.

The pressures of a looming election or the **influence exerted by special interest groups** can foster an environment in which inappropriate spending and tax decisions are made. - e.g. boosting welfare spending in the run up to an election, or bringing forward major items of capital spending on infrastructural projects without the projects being subjected to a full and proper **cost-benefit analysis** to determine the likely **social costs and benefits**. Critics of current government policy towards tobacco taxation and advertising, and the controversial issue of genetically modified foods argue that government departments are too sensitive to political lobbying from the major corporations.

(b) Policy myopia

Critics of government intervention in the economy argue that politicians have an in-built tendency to look for **short term solutions to difficult economic problems** rather than making considered analysis of long term considerations.

Two recent examples come to mind. Firstly the view (translated into policy) that building more roads (and widening existing roads and motorways) is the most effective strategy to combat the worsening problem of traffic congestion.

A decision to build more roads and by-passes might simply add to the problems of traffic congestion in the long run encouraging an increase in the total number of cars on the roads. The Commission for Integrated Transport has criticised the Government for a failure to develop a properly integrated transport policy. They clearly believe that government failure is endemic in our transport industry – although we should remember that their view is normative, based on value judgements!

Secondly criticisms of the huge increases in state spending on the National Health Service. Government critics argue that much of the extra spending is being "lost" in higher pay and administration rather than finding its way into improving front-line health services.

The risk is that myopic decision-making will only provide short term relief to particular problems but does little to address structural economic problems.

Critics of **government subsidies** to particular industries also claim that they distort the proper functioning of markets and lead to **deeper inefficiencies** in the economy. For example short term financial support to coal producers to keep open loss-making coal pits might eventually prove to be a waste of scarce resources if the industry concerned has little realistic prospect of achieving a viable economic rate of return in the long run given the strength of global competition. And also the opportunity to import fuels more cheaply from overseas adds to economic welfare because it is based on the theory of comparative advantage.

(c) Regulatory capture.

This is when the industries under the control of a regulatory body (i.e. a government agency) appear to operate in favour of the vested interest of producers rather can consumers. Some economists argue that regulators can prevent the ability of the market to operate freely. We might find examples of this in agriculture, telecommunications, the main household utilities and in transport regulation.

For example, to what extent has the system of agricultural support known as the **Common Agricultural Policy** (or CAP) operated too much in the interests of farmers and the farming industry in general? And as a result, has the CAP worked against the long-term interest of **consumers**, the **environment** and **developing countries** who claim that they are being unfairly treated in world markets by the effects of import tariffs on food and export subsidies to loss-making European farmers? The CAP is widely criticised as a classic example of government failure and there are many who claim that the current reform process does not go far enough.

(d) Government intervention and disincentive effects

Free market economists who fear government failure at every turn argue that attempts by the government to reduce income and wealth inequalities can actually worsen **incentives** and **productivity** in the economy. They would argue against the **National Minimum Wage** because they believe that it artificially raises wages above their true free-market level and can lead to real-wage unemployment. They would argue against raising the **higher rates of income tax** because it is deemed to have a negative effect on the incentives of wealth-creators in the economy and generally acts as a disincentive to work longer hours or take a better paid job. They are critical of the government focusing welfare benefits on the poorest using **means-tested benefits** because they believe that this too damages the incentive to find work.

(e) **Government intervention and evasion**

A decision by the government to raise taxes on de-merit goods (such as cigarettes) might lead to an increase in attempted **tax avoidance, tax evasion, smuggling and the development of grey markets** where trade takes place between consumers and suppliers without paying tax. Equally a decision to legalize and then tax some drugs might lead to a rapid expansion of the supply of drugs and a substantial loss of social welfare arising from over consumption.

(f) Policy decisions based on imperfect information

How does the government establish what citizens want it to do in their name? Can the government ever really know the true **revealed preferences** of so many people? Our current electoral system is not an ideal way to discover this! Turnout in every type of election, (local, national, European etc) is falling, there is general disinterest in the political process. Furthermore, people rarely vote purely out of their own self-interest or on the basis of a well informed and rational assessment of the costs and benefits of different government policies.

Proponents of government failure argue that the free market mechanism is, in the long-run, the best way of finding out

(a) What consumer preferences are **and**

(b) Aggregating these preferences based on the number of people that are willing and able to pay for particular goods and services.

Often a government will choose to go ahead with a project or policy without having the full amount of information required for a proper **cost-benefit analysis**. The result can be misguided policies and damaging long-term consequences.

How does the government know how many extra houses need to be built in the UK over the next twenty years? Is building thousands of extra homes in an already congested South-east the right option? Are there better solutions? But ones that politically may not be feasible? There have been plenty of instances of government housing policy having failed in previous decades!

(g) The Law of Unintended Consequences!

This law lies at the heart of many of the possible causes of government failure in markets!

The law of unintended consequences is that actions of consumer and producers — and especially of government— always have **effects that are unanticipated or "unintended."** Particularly when economic agents do not always act in the way that the economics textbooks would predict – this is of course the essence of a social, behaviour science – we do not live our lives in sanitised laboratories where all of the conditions can be controlled.

The law of unintended consequences is often used to criticise the effects of government legislation, taxation and regulation. People find ways to circumvent laws; shadow markets develop to undermine an official policy; people act in unexpected ways because or ignorance and / or error. Unintended consequences can add hugely to the financial costs of some government programmes so that they make them extremely expensive when set against their original goals and objectives.

Landfill - In the mid 1990s, the government introduced a Landfill tax designed to raise the price (cost) of using landfill sites to dump household and industrial waste and thereby encourage a switch to re-cycling and incineration (deemed to be friendlier to the environment in the long term). The effects have been very costly. Little progress has been made in reducing the volume of waste recycled and thousands of people opted to fly-tip their waste on open land rather than pay the higher cost at a landfill site.

Steel tariffs – a self-inflicted wound for the USA?

The negative economic consequences of imposing tariffs on imports are widely understood. But they are often dismissed by politicians whose justification for introducing trade barriers is often far divorced from economic principles.

A report from the US International Trade Commission found that the 30% steel tariffs imposed by the US in an attempt to save jobs merely increased unemployment among car workers. The ITC's report found that although there have been some gains for steel producing areas, overall the effect on the US economy had been a loss to GDP of $30m (£18m). And steel tariffs failed to prevent further reductions in employment in the steel industry. The number of U.S. workers employed by manufacturers of basic steel products and in blast furnaces and steel mills declined by 17 percent and 19 percent, respectively, from 1999 through 2002 and again in 2003. Car manufacturers in the USA were opposed to the increased costs of their steel inputs which led them to have to source their steel from more expensive domestic (US) suppliers. 20,000 and 40,000 car job losses were attributed to the steel tariff. The World Trade Organisation (WTC) ruled in July 2003 that the US steel tariffs broke international trade rules – eventually the Bush administration backed down and repealed them.

(h) Costs of administration and enforcement

Government intervention can prove costly to administer and enforce. The estimated social benefits of a particular policy might be largely swamped by the administrative costs of introducing it.

A summary of the arguments

1. **Free market economists** are naturally distrustful of government intervention in the economy
2. They believe that the **signalling, incentive and rationing functions of the price mechanism** should be given more freedom to operate
3. They believe that government failure can occur at a **microeconomic level** (e.g. introducing minimum prices in markets, rent controls, producer subsidies etc) and at a **macroeconomic level** (pursuing inappropriate exchange rate, tax or interest rate policies etc)
4. When government failure exists, the result can be a **deepening of an existing market failure**

5. The result is a further **loss of allocative and productive efficiency** because of the waste of scarce resources – leading to a **reduction in consumer and producer welfare**
6. Often we can accuse the government of policy failure only with the **benefit of hindsight**
7. **Limited information** - no government has the resources and information available to it to make fully-informed, objective judgements. That is the nature of politics.
8. Government failure is most likely to occur when decisions are made in the **vested interest of special interest groups**, at the expense of other groups (the result is a **loss of equity**)
9. But **government failure is rarely total**. Policies may be ineffective, expensive and inefficient – but providing that policies are flexible and adaptable, (i.e. lessons are learned) then intervention can often work in the interests of the majority
10. Advances in our understanding of how consumers and businesses behave and respond to changing incentives are helping government policies to evolve. For example the growing interest in **auctions and traded permits** as a means of controlling pollution and other forms of environmental damage